Amundi ASSET MANAGEMENT

RESEARCH STRATEGY & ANALYSIS

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Our convictions

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The election of D. Trump to the presidency of the United States had several major consequences on the financial markets:

- **Firstly, a repricing of growth prospects, inflation expectations, and a clear rise in bond yields**, which is particularly significant in an environment previously determined by debates on secular stagnation and on the end of inflation. The question is whether this repricing is justified in the short term only or in the long term too. In short, are we seeing an extension of the current cycle of growth (which was slowing down) or rather at the very beginning of a new breath and a new cycle of growth?

A novelty for many years: tensions between the Fed and the US administration

- Moreover, in a world dominated by accommodative monetary policies and reinforcing the growth policies desired by the governments, **strong tensions emerged between the new US administration and the Fed on the conduct of monetary policy first, and most recently on the current (deemed "unacceptable") role of the Fed in regulation (including banking).** Apart from the fact that Janet Yellen will probably not be re-appointed to her position in 2018, we can expect the rising tensions between Fed and Administration Trump, which will add volatility to the markets.

Economic auto-centrism does not bode well for international relations and global growth

- **The debate on protectionism is also seriously worrying**. The story is filled with episodes of this kind that do not incite optimism in terms of economic expansion. This theme comes at a time when trade in goods is falling sharply, and it is well known that the expansion of trade has been accompanied by foreign policies marked by openness. **Economic self-centrism does not augur well for international relations.** US protectionist tendencies have already translated into diplomatic and economic tensions with China (which has tightened its capital controls), Mexico and even Japan.

United States: betting on an extension of the current cycle is reasonable at this stage ... believing in a new cycle of growth or an improvement in potential growth is excessive for now

In total, our beliefs are:

- **Leveraging an extension of the current cycle is reasonable at this stage... believing in a new cycle of growth or an improvement in potential growth is excessive for the time being**. Although US growth will benefit from a more generous fiscal and tax policies, we should not see a new, more robust, growth cycle. Nevertheless, **careful attention will be paid to future taxation decisions, including those relating to corporate taxation**, which will give new impetus to the equity market.

Equity markets: our country choices between Japan, the United States and Europe are not very marked, although we currently have a slight preference for the euro area

- Despite this, **the context has once again become favorable to the equity**

market, notably on US domestic themes (Small cap - Mid cap, domestic demand, and cyclical sectors). However, we have reduced these exposures to the benefit of the European market, which seems promising and especially less risky in terms of valuation. Before the election of D. Trump, we considered excessive the valuation of the US market (large caps and SMID caps). In other words, this is still the case if we do not believe in a new cycle of growth and profits. The next publication of corporate results (mid-March) will be the "Justice of the Peace". **At the moment, the country allocation between Japan, the United States and Europe are rather similar, although we currently have a slight preference for the euro area.** The "quality" factors in the United States and "value" have returned to the forefront in our allocations.

Corporate bond markets: staying overweight

- Same for corporate bonds: **our portfolios are overweight in this asset class, both in the US and Europe**. It should be noted, however, that US bonds, given the leverage of US companies, are more vulnerable than their European counterparts to any rate hike and bond yield increase.
- **US Bond yields rises will not last: we are experiencing an episode of fluctuation band change, not a change in regime**. The rate differential with Europe or Japan in particular, or the term premiums should soon return interest to US government bonds. Note that these are of particular interest for the carry they offer, but also for the natural qualities of macro-hedging in the event of difficulties in the emerging world, or in Europe.

US bond yields will not rise in a sustainable manner and are already recovering some of their carry and macro-hedging qualities

- In an environment of slowly and temporarily rising US bond yields, **do not expect a sharp rise in long-term rates in Europe, especially as the ECB continues to buy far more than net issues of the whole euro zone.** The end of the ECB's QE would mean a steep rise in German 10-year bond yield (+ 150bp to be in line with their equilibrium value) and peripheral countries yields (between 250bp and 350bp depending on the country), so to say a bond market crisis. The risk will not come in 2017 from the ECB, but **the rising political risks will keep bond spreads (vs. Germany) at higher levels than in the past two years**. **The key issue of the Dutch, Italian or French elections is dealing with the future of Europe**, and that is why all spreads will be affected. **Stay away from countries with low solvency and high political instability or uncertainty.**
- **Inflation has risen in the United States, mainly as a result of rising commodity prices, and this fuels inflation expectations, validating rate hikes by the Fed**. The rise in prices will soon be above the Fed target (2%) and fears that inflation will continue to rise have become a major theme again. These fears seem to be largely exaggerated at this stage of growth, but it was enough to make us look closely at **inflation-linked bonds**. We decided to return to these markets in the first quarter of 2016 because of the macro-hedging qualities of this asset class, which were also considered attractive for their extremely low valuation and their enormous underweight in the portfolios. We are now invested for reasons related to their own fundamentals, including the inflation cycle and higher oil prices (for short maturities as far as oil prices are concerned).

Europe: do not expect a strong rise in bond yields in Germany, but expect higher spreads on sovereigns, given the political context

- **The Fed will not be aggressive in its rate hikes. We are still not entering a monetary normalization cycle**, which is very different from the one initiated by the Fed in 1995 (+ 300bp in one year) or 2004 (+ 425bp in two years). It will certainly take advantage of the current situation ("repricing" of growth, economic policy and inflation expectations) to restore room for manoeuvre, but effective conditions (potential growth, corporate indebtedness, real Inflation…) should not allow it to carry out many monetary tightening. **We expect two rate hikes in 2017**.

Fed: two rate hikes in 2017, but still no real normalisation

- Even if D. Trump's election to the US presidency has hijacked many emerging market investors (political tensions, fears of protectionist measures, frontal political attacks…) and has also prompted us to reduce our exposure, **we maintain our view in the medium term: the EMG markets retain many assets. Attractive valuations, undervalued currencies, large underweights in portfolios, potentially high capital flows… all this justifies remaining positive** (for more details, refer to our January edition, pages 10 and 11 for China, pages 11 and 12 for emerging markets in general). We expect a good performance of these markets in 2017. **At the moment, we are under-exposed in emerging currencies, emerging equities and debt products**. We nevertheless prefer hard currency debt to the detriment of local currency debts. The latter has a high potential… but later on.

Bonds indexed to inflation: our investment was as much on US securities as on their European counterparts

- **Our long USD view is maintained**, given the divergence in the dynamics of growth expectations, the widening of the spreads between the United States and Japan \ Europe, and the different orientations of monetary policies. Moreover, the weakness of the emerging currencies should not really reverse as long as fears of protectionist measures remain.

Staying long USD seems appropriate in the current context

- **Macro-hedging policies are maintained.** The global geopolitical context, the diplomatic tensions between the United States and some major countries (China…) and the political context in Europe justify some protection measures. US Treasuries markets, volatility, cash in USD and inflation-linked bonds are particularly interesting from this point of view. For those who wager on more serious warning shots, also having long gold positions becomes essential.

Keep safeguards in a context of greater volatility

The table below summarizes our asset allocations for bond, equity, and multi-asset portfolios.

Portfolio type

> Equity portfolios

- Preference for eurozone equities vs. US
- European Sectors:
  overweight Healthcare, neutral on REITs, underweight Banks, Greece and Portugal
- US Sectors:
  - Overweight cyclicals, financials, small and mid caps (domestic plays)
  - Underweight global trade plays
- Emerging markets: globally cautious. Within emerging markets:
  - Overweight: India, Peru, Philippines, Russia, Mexico
  - Underweight: China, Taiwan, Greece, Turkey, South Africa, Brazil
- Positions in EMG currencies drastically revised down

> Bond portfolios

- Slightly underweight risky assets
- Underweight US govies
- Overweight position in Euro credit reduced
- Overweight position in US credit
- Long on European financials (but remain selective)
- Duration: globally neutral to short, with a short bias on negatively yielding segments
- Short duration on USD, GBP and JPY
- Long on US and Euro real bonds
- Emerging debt:
  - Prefer hard currency debt (long USD)
  - Local debt component drastically underweighted
- Long USD vs. EUR and JPY
- Few long positions in EMG commodity currencies

> Diversified portfolios

- Long positions on “value” factor and European financials
- Overall positive on Japanese equities (JPY hedged)
- Few long positions in EMG currencies, EMG debt (and EMG equities)
- Significant preference for EMG debt in hard currencies
- Keep the overweight in euro peripheral bonds (excluding Italy) vs. core
- Long US govies (carry and macro-hedging purposes) maintained
- Corporate bonds: positive on HY and IG, especially in the US
- Positive views on breakeven inflation (all regions)

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